DOD FINANCIAL MANAGEMENT

Greater Visibility Needed to Better Assess Audit Readiness for Property, Plant, and Equipment

May 2016
Great Visibility Needed to Better Assess Audit Readiness for Property, Plant, and Equipment

What GAO Found

The Department of Defense (DOD), reporting about $630 billion total Property, Plant, and Equipment (PP&E) net of accumulated depreciation as of September 30, 2015, is responsible for over 70 percent of the U.S. government’s reported PP&E. However, as GAO and others have previously reported—and made recommendations to address—DOD’s accountability over and ability to value its PP&E assets has for years been challenged by poorly designed internal controls, processes, and systems. These challenges are highlighted by DOD’s inability to prepare auditable financial statements.

The military services have asserted audit readiness regarding PP&E accountability for some categories of PP&E. However, they have not yet asserted audit readiness for certain key categories of PP&E, including land, government-furnished equipment, and internal-use software. In addition, the Marine Corps (a component of the Navy) has not yet asserted audit readiness for any of its PP&E. While the services have set target dates for asserting audit readiness for these remaining assets, almost all of the target dates have been delayed in some cases by multiple years, increasing the risk that DOD may not complete audit readiness efforts by the target date of September 30, 2017.

DOD reports its audit readiness status and progress in its semiannual Financial Improvement and Audit Readiness (FIAR) Plan Status Report. However, the Status Report does not provide clear visibility for Congress and other decision makers regarding the extent to which DOD has addressed deficiencies in the related internal controls. For example, the military services have asserted audit readiness regarding PP&E accountability for some individually large-value and high-visibility equipment, such as ships and aircraft. However, the Status Report does not reflect that the services have often asserted audit readiness without evaluating or correcting the underlying internal control deficiencies. Similarly, DOD identified a number of deficiencies, referred to as dealbreakers, that it reports to be so severe that they could prevent the services from demonstrating audit readiness or succeeding in audits—such as the inability to produce a complete list of items the services own. However, DOD’s Status Report does not provide adequate visibility over actions taken and progress made toward correcting those dealbreakers. Without greater visibility of DOD’s audit readiness status and progress in its FIAR Plan Status Report, Congress and other decision makers may not have sufficient information to assess DOD’s current audit readiness status and the improvements that still need to be made.

Regarding valuation, DOD is in the early stages of developing specific methodologies and procedures to value its existing PP&E assets. DOD estimates that it needs to value over 440,000 real property assets and several hundred thousand individual pieces of equipment. Proposed changes to federal accounting standards would provide DOD more options for estimating the value of its existing assets. However, DOD reported that previously identified systems and control deficiencies impair its ability to properly account for the actual costs of newly acquired assets, and identified fixing such deficiencies as a priority in the FIAR Plan.
Contents

Letter

Background
DOD and the Military Services’ Efforts to Assert Audit Readiness for PP&E Are Behind Schedule, and Status Reports Do Not Include Sufficient Information to Assess Progress
DOD’s Plans for Valuing PP&E Are in the Early Stages of Development

Conclusions
Recommendations for Executive Action
Agency Comments and Our Evaluation

Appendix I
Objectives, Scope, and Methodology

Appendix II
Comments from the Department of Defense

Appendix III
GAO Contact and Staff Acknowledgments

Table
Table 1: Department of Defense’s Reported Property, Plant, and Equipment Assets as of September 30, 2015

Figure
Figure 1: Changes in Military Services’ Planned Assertion Dates for Property, Plant, and Equipment Audit Readiness
## Abbreviations

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>DOD</td>
<td>Department of Defense</td>
</tr>
<tr>
<td>FASAB</td>
<td>Federal Accounting Standards Advisory Board</td>
</tr>
<tr>
<td>FIAR</td>
<td>Financial Improvement and Audit Readiness</td>
</tr>
<tr>
<td>IUS</td>
<td>internal-use software</td>
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<tr>
<td>NDAA</td>
<td>National Defense Authorization Act</td>
</tr>
<tr>
<td>OIG</td>
<td>Office of Inspector General</td>
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<tr>
<td>OMB</td>
<td>Office of Management and Budget</td>
</tr>
<tr>
<td>PP&amp;E</td>
<td>Property, Plant, and Equipment</td>
</tr>
<tr>
<td>SFFAS</td>
<td>Statement of Federal Financial Accounting Standards</td>
</tr>
</tbody>
</table>

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May 26, 2016

Congressional Committees

The successful execution of the Department of Defense’s (DOD) military mission depends on a properly equipped and supplied force. DOD and the military services collectively hold hundreds of thousands of unique assets at thousands of worldwide locations. Accountable property systems capable of providing reliable information concerning mission-critical assets are important both operationally as well as to provide the financial information DOD managers need in making decisions about allocating scarce resources, authorizing and modifying programs, and evaluating program performance.1

In its 2015 financial statements, DOD reported $427 billion of equipment and $157 billion of real property, both net of applicable accumulated depreciation.2 However, DOD reported that its financial statements did not substantially conform to accounting requirements and that the department’s financial management and feeder systems were unable to adequately support material amounts on the basic financial statements. In addition, DOD reported several auditor-identified material weaknesses related to Property, Plant, and Equipment (PP&E).3 DOD’s serious financial management problems, which have resulted in unauditable financial statements, are one of the three impediments that continue to

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1Accountable property systems provide details used to control and manage Property, Plant, and Equipment assets and supporting records from an asset’s acquisition through final disposition using a system that is integrated with the core financial accounting system.


3Financial Improvement and Audit Readiness Guidance of April 2015 defines PP&E to include (1) equipment, such as ships, aircraft, combat vehicles, material handling equipment, training equipment, special tooling, and special test equipment; (2) real property, such as land, buildings, structures, and facilities; and (3) internal-use software.
preclude GAO from rendering an opinion on the U.S. government’s accrual-based consolidated financial statements.⁴

DOD’s ability to properly account for all of its PP&E assets in its accountable property systems, and record a value for each asset, has for years been hampered by poorly designed internal controls, processes, and systems. DOD’s challenges in performing basic financial and accountability functions are highlighted by its inability to prepare auditable financial statements—one measure of good financial management. DOD’s Financial Improvement and Audit Readiness (FIAR) Plan provides the strategy for DOD’s financial management reform efforts. The Senate report accompanying S.2410, a bill for the National Defense Authorization Act for Fiscal Year 2015, included a provision for GAO to review DOD’s plans for achieving audit readiness with respect to its PP&E.⁵

This report addresses the reported status of DOD’s and the military services’—the departments of the Army, Navy (including the Marine Corps), and Air Force—(1) assertions of audit readiness for PP&E asset accountability in accordance with the FIAR Guidance and (2) plans for valuing PP&E assets. According to DOD’s FIAR Guidance, to assert audit readiness means the department or service formally declares that it has strengthened internal controls and improved financial practices, processes, and systems so there is reasonable confidence that the information can undergo an audit by an independent auditor.

To address the first objective, we reviewed the status of the military services’ efforts to become audit ready regarding their accountability for General Fund PP&E (which represents approximately 85 percent of DOD’s total reported PP&E asset value) as reported in the most recent FIAR Guidance.⁶ We interviewed Army, Navy, and Air Force officials and analyzed documentation to gain an understanding of their processes and

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⁶The General Fund includes appropriated funding for personnel, operation and maintenance, procurement, research and development, and military construction. It does not include the Working Capital Fund, which is funded primarily from fees charged for goods and services provided to customers.
systems for documenting and reporting their PP&E accountability and asserting audit readiness. We evaluated the documentation the military services prepared to support their assertions using the applicable FIAR Guidance. We also reviewed the semiannual FIAR Plan Status Reports issued from November 2010 to November 2015, in order to determine the reported overall status of the services’ PP&E audit readiness assertions.

To address the second objective, we conducted interviews and reviewed DOD’s overall plans and methodologies for valuing equipment and real property. We also monitored Federal Accounting Standards Advisory Board (FASAB) proceedings and discussions regarding proposed changes to accounting standards for the valuation of PP&E.7

We conducted this performance audit from November 2014 to May 2016 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. Further details on our scope and methodology are provided in appendix I.

Background

Since 1997, DOD has been required to prepare annual audited department-wide financial statements. However, our prior work has shown that long-standing and pervasive financial management weaknesses have precluded DOD from being auditable. Specifically, GAO has reported that the efforts of DOD components to date to implement the FIAR Guidance have not resulted in a fundamental transformation of systems and operations necessary to resolve the department’s long-standing financial management deficiencies. Resolution of these deficiencies will be crucial to DOD’s efforts to meet the target date for validating audit readiness of DOD’s full financial statements.

7FASAB is a federal advisory committee sponsored by the Office of Management and Budget, the Department of the Treasury, and GAO.
We and other auditors have over the course of many years reported multiple deficiencies in systems and controls over PP&E, and have made many recommendations to DOD to remedy the deficiencies. For example, the DOD Office of Inspector General (OIG) in its July 2015 summarization of audits on DOD financial management challenges noted that it had issued 43 reports discussing deficiencies in DOD’s PP&E, and that of the 131 open recommendations aimed at resolving deficiencies preventing DOD from achieving auditability, there are numerous open recommendations pertaining to remediating weaknesses in DOD’s financial systems and controls over PP&E.8

DOD is responsible for over 70 percent of the federal government’s reported PP&E. However, since 1995 DOD’s financial management has been on GAO’s list of federal programs and operations at high risk of being vulnerable to fraud, waste, and abuse.9 This is due to financial management deficiencies and related business management system and control weaknesses that have adversely affected DOD’s ability to (1) control costs; (2) ensure basic accountability; (3) anticipate future costs and claims on the budget; (4) measure performance; (5) maintain funds control; (6) prevent and detect fraud, waste, and abuse; (7) address pressing management issues; and (8) prepare auditable financial statements. Without accurate, timely, and useful financial information, our prior work has shown that DOD and others are severely hampered in making sound decisions affecting its operations.10 Further, to the extent that current budget constraints and fiscal pressures continue, the reliability of DOD’s financial information and ability to maintain effective

8The DOD OIG further reported that DOD acknowledged that it did not have adequate internal controls in place to provide reasonable assurance that certain PP&E was identified and properly reported or that other PP&E could be accurately valued, the collective result being an increased risk in materially misstated financial statements. See Department of Defense, Office of Inspector General, Summary of DoD Office of Inspector General Audits of DoD Financial Management Challenges, DOD-OIG-2015-144 (Washington, D.C.: July 7, 2015), and Department of Defense, Agency Financial Report Fiscal Year 2015.

9GAO maintains an ongoing program to focus on government operations that are at high risk because of their greater vulnerabilities to fraud, waste, abuse, and mismanagement or that need transformation to address economy, efficiency, or effectiveness challenges. See GAO, High-Risk Series: An Update, GAO-15-290 (Washington, D.C.: Feb. 11, 2015).

accountability for its resources will be increasingly important to the federal government’s ability to make sound resource allocation decisions.

The National Defense Authorization Act (NDAA) for Fiscal Year 2010 required that DOD develop and maintain the FIAR Plan.\textsuperscript{11} The FIAR Plan must include specific actions DOD plans to take to help correct deficiencies that impair DOD’s ability to prepare timely, reliable, and complete financial management information and ensure that its financial statements are validated as ready for audit by September 30, 2017. The NDAA for Fiscal Year 2010 also required DOD to implement semiannual status reporting on the FIAR Plan to the congressional defense committees. These status reports can also be used by other decision makers to help in their oversight responsibilities. The FIAR Plan Status Report, nearly 300 pages long in its most recent update, communicates the broad issues impeding the reliability of DOD’s financial statements and discusses department-wide initiatives to address them.\textsuperscript{12} Impediments to accurately reporting PP&E is one of many issues separately discussed in the report, as well as department-wide initiatives and service-specific impediments to other financial report line items, such as inventory and accounts payable, and impediments to financial statements, such as the Statement of Budgetary Resources.

Further, the NDAA for Fiscal Year 2014 mandated a full audit of DOD’s fiscal year 2018 financial statements and submission of those results to Congress by March 31, 2019.\textsuperscript{13} The military services are required to prepare and issue annual audited financial statements,\textsuperscript{14} from which DOD consolidates the component financial statements to prepare its

\textsuperscript{11}Pub. L. No. 111-84, § 1003(a), (b), 123 Stat. 2190, 2439-40 (Oct. 28, 2009), as amended.


department-wide financial statements. As prescribed by Office of Management and Budget (OMB) and DOD policy for the preparation and audit of agency financial statements, DOD and its components must prepare their financial statements consistent with U.S. generally accepted accounting principles and establish and maintain effective internal control over financial reporting and compliance with laws and regulations.

The FIAR Plan—first issued in 2005 and updated semiannually through status reports—provides the strategy for DOD’s financial management reform efforts. It is DOD’s strategic plan and management tool for guiding, monitoring, and reporting on the department’s financial management improvement efforts. As such, the plan communicates progress in addressing the department’s financial management weaknesses and achieving financial statement auditability. The plan focuses on several goals, which include the following.

1. Achieve and sustain effective internal controls through the implementation of sustained improvements in business processes and controls addressing the material weaknesses in internal control.

2. Develop and implement financial management systems that support effective financial management.

3. Achieve and sustain financial statement audit readiness.

In May 2010, the DOD Comptroller first issued the FIAR Guidance, which provided a standard methodology for components to follow in implementing the FIAR Plan. DOD has stated that the components’ successful implementation of this methodology is essential to its ability to achieve full financial statement auditability.

In its financial statements and notes to the financial statements, DOD presents details of its balance sheet account General PP&E, which comprises major asset classes, such as

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15While DOD’s annual consolidated financial statements are subject to audit procedures, the auditors have been unable to determine whether the financial statements are fairly presented and have therefore issued a disclaimer of opinion since fiscal year 1997.

16Generally accepted accounting principles for federal agencies are issued by FASAB.

17The FIAR Guidance was most recently updated in April 2015.
• equipment, which includes military equipment, such as ships, aircraft, and combat vehicles, government-furnished equipment held by contractors,18 and other equipment, such as material handling equipment, training equipment, special tooling, and special test equipment;

• real property, which includes land, buildings, structures, facilities, and leasehold improvements;

• internal-use software (IUS), which represents the cost of software whether commercial off-the-shelf, internally developed, or contractor developed; and

• other, which includes construction-in-progress whether for real property structures or equipment that is being constructed and not yet placed in service.

Table 1 provides DOD’s PP&E asset categories and reported values as of the end of fiscal year 2015. While information presented in table 1 has been obtained from DOD’s published financial statements, DOD management reported that the financial statements did not substantially conform to accounting requirements and that DOD financial management and feeder systems were unable to adequately support material amounts on the basic financial statements.19 Consequently, the financial auditors could not obtain sufficient, reliable information regarding the reliability of reported amounts.

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18Government-furnished property, which includes government-furnished equipment, is property in the possession of, or directly acquired by, the government and subsequently furnished to the contractor for performance of a contract. Government-furnished property includes property furnished for repairs, maintenance, overhaul, or modification of military equipment. Government-furnished property may also include vendor-acquired property if the property is a requirement or a provision of a contract with the government. Federal Acquisition Regulation § 45.101.

Table 1: Department of Defense’s Reported Property, Plant, and Equipment Assets as of September 30, 2015

<table>
<thead>
<tr>
<th>Major Property, Plant, and Equipment (PP&amp;E) asset classes</th>
<th>Acquisition value</th>
<th>Net book value</th>
<th>Percentage of net value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equipment</td>
<td>$1,010,573</td>
<td>$426,533</td>
<td>68%</td>
</tr>
<tr>
<td>Real property</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Land</td>
<td>10,904</td>
<td>10,904</td>
<td>2%</td>
</tr>
<tr>
<td>Buildings, structures, and facilities</td>
<td>283,181</td>
<td>146,263</td>
<td>23%</td>
</tr>
<tr>
<td>Internal-use software</td>
<td>12,022</td>
<td>3,596</td>
<td>&lt;1%</td>
</tr>
<tr>
<td>Other (including construction-in-progress)</td>
<td>43,149</td>
<td>42,701</td>
<td>7%</td>
</tr>
<tr>
<td>Total PP&amp;E</td>
<td>$1,359,829</td>
<td>$629,997</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: GAO’s analysis of data from the Department of Defense’s Agency Financial Report Fiscal Year 2015, which received a disclaimer of opinion from the auditors. 1 GAO-16-383

*Net book value represents asset acquisition value less accumulated depreciation as of September 30, 2015. Annual depreciation expense is calculated over the estimated service life of the asset.

DOD faces challenges in its efforts to provide reasonable assurance of accountability for its PP&E—knowing what it has, where it is located, what condition it is in, and its depreciated cost. Although DOD has been working to address previously reported deficiencies by improving its systems and procedures, a substantial amount of work remains before DOD can demonstrate that the full portfolio of PP&E assets is reliably reported in the financial statements. Congress has mandated that DOD take steps to be audit ready by September 30, 2017.20

As defined in the FIAR Guidance, an audit-ready entity is one that has strengthened internal controls and improved financial practices, processes, and systems so that it has reasonable confidence the resulting information can undergo an audit by an independent auditor.21

The military services have asserted that some individually large-value and

20Pub. L. No. 111-84, § 1003(a), (b), as amended.

21To undergo an audit does not necessarily mean that the department is representing that it will receive an unmodified (clean) opinion on the information being audited, but rather that there is a reasonable basis for an independent auditor to audit the information. DOD reported in its November 2015 FIAR Plan Status Report that it is unlikely it will receive an unmodified auditor’s opinion for the first few years under audit, citing that DOD (1) is a vast and complex organization, (2) must remediate deficiencies while also supporting the warfighter, and (3) must undergo what is likely the largest audit ever undertaken.
high-visibility equipment (such as ships, submarines, and aircraft) are ready for audit. However, they have also reported that they have not completed validation of the accountability over certain key classes of PP&E and therefore have not yet asserted audit readiness for such assets, including land, government-furnished equipment, and IUS. For the latter two asset classes, DOD has stated that it does not have an accurate estimate of what it has or where it is located. The Army, for example, indicated in a report related to property and equipment held by contractors that it does not know the actual amount of these assets but anticipates that actual quantities may be greatly different than the Army’s documented property records reflect. Moreover, the Marine Corps (a component of the Navy) has not yet asserted audit readiness for any of its PP&E.

While the military services have set target dates for asserting audit readiness for its PP&E, almost all of the target dates have been delayed, in some cases by multiple years, increasing the risk that DOD may not complete audit readiness efforts by the target date of September 30, 2017. Figure 1 shows that some planned assertion dates have been significantly extended.
Figure 1: Changes in Military Services' Planned Assertion Dates for Property, Plant, and Equipment Audit Readiness

<table>
<thead>
<tr>
<th>Category</th>
<th>Timeline of changes in assertion dates</th>
</tr>
</thead>
<tbody>
<tr>
<td>Army</td>
<td></td>
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<tr>
<td>Real property</td>
<td></td>
</tr>
<tr>
<td>Equipment(^a)</td>
<td>DEC 2012</td>
</tr>
<tr>
<td>Internal-use software(^b)</td>
<td></td>
</tr>
<tr>
<td>Navy</td>
<td></td>
</tr>
<tr>
<td>Real property</td>
<td></td>
</tr>
<tr>
<td>Equipment(^a,c)</td>
<td>MAR 2013</td>
</tr>
<tr>
<td>Internal-use software(^b)</td>
<td></td>
</tr>
<tr>
<td>Air Force</td>
<td></td>
</tr>
<tr>
<td>Real property(^c)</td>
<td>JUN 2013</td>
</tr>
<tr>
<td>Equipment(^a)</td>
<td></td>
</tr>
<tr>
<td>Internal-use software(^b)</td>
<td></td>
</tr>
</tbody>
</table>

Source: GAO analysis of November 2010-2015 FIAR Plan Status report updates | GAO-16-383

\(^a\) Some portions of equipment, that is, military equipment, have been asserted by the military services as audit ready.

\(^b\) The planned assertion date for internal-use software was first reported in the November 2014 Financial Improvement Audit Readiness (FIAR) Status Plan report.

\(^c\) Based on GAO review, the assertions for these asset categories remain incomplete. A new target date has not been reported.
Although the services have asserted that several categories of equipment, particularly military equipment, are audit ready, in some assertions they reported that they did not evaluate or correct identified internal control deficiencies in accordance with the FIAR Guidance prior to asserting audit readiness. In some cases, the services acknowledged that controls were inadequate to be relied on as a basis for the assertions. For example, while the Army asserted audit readiness for some of its real property, it reported that internal controls for certain real property acquisitions and disposals were not operating effectively and deficiencies identified had not been remediated. The Navy asserted some categories of its equipment as audit ready and that key controls were designed and operating effectively. However, the Navy reported that test results for four of seven key controls had failure rates in excess of limits established in the FIAR Guidance. Though the Navy has developed corrective action plans, it had not remediated all of the identified deficiencies prior to asserting audit readiness. The Air Force also asserted in August 2015 that certain equipment, such as support equipment and vehicles, was ready for audit. Yet, according to an Air Force official, the service was unable to reconcile the assets from the accountable property system to amounts in the financial statements.

Additionally, DOD has acknowledged a set of control deficiencies, identified as “dealbreakers,” that it reports are so severe that they could prevent the services from demonstrating audit readiness or succeeding in audits. These dealbreakers, first reported in the May 2015 FIAR Plan Status Report, include the inability to reconcile transaction detail to the

22The House Armed Services Committee Panel on Defense Financial Management and Auditability Reform has expressed concern that DOD components have asserted audit readiness without addressing fundamental issues, such as improving internal control. (House Armed Services Committee Panel on Defense Financial Management and Auditability Reform, Findings and Recommendations (Washington, D.C.: Jan. 24, 2012).) Additionally, as we stated in our most recent high-risk report, DOD has emphasized asserting audit readiness by set dates over assuring that processes, systems, and controls are effective, reliable, and sustainable (GAO-15-290).

23The Navy defined these categories of equipment as remaining equipment—all Navy PP&E not accounted for in the prior equipment assertions covering ships/submarines, aircraft, trident missiles, small boats, and satellites. The remaining equipment assertion does not include the United States Marine Corps’ PP&E assets.
Instead of addressing previous auditor-reported deficiencies and developing effective controls over the accountability of PP&E, the services generally focused on counting assets at a point in time as a basis for asserting audit readiness. However, as discussed, without effective controls, management cannot reasonably assure the ongoing accuracy of the asset accountability records and routinely generate timely, complete, and reliable financial information to manage its assets.\(^{26}\) In addition, absent effective controls, auditors may need to count substantially more items every year, at multiple locations, in order to assess the reliability of assets recorded in DOD's accountable property systems. More extensive testing may not be practical given the volume of PP&E assets. To illustrate, the Army has reported that it has approximately 250,000 individual pieces of equipment spread out among many bases all over the world.

Although the military services' assertions for being audit ready are reported in DOD's semiannual FIAR Plan Status Report, the report does not include information for decision makers about which assertions were made based on counting assets at a point in time without correcting

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\(^{24}\) A general ledger is the master set of accounts that summarizes all transactions occurring within an entity. The general ledger accounting system works as a central repository for accounting data transferred from all subsidiary ledgers, or accounting system modules, and includes budgetary and proprietary transactions. The general ledger contains a debit and credit entry for every transaction recorded within it, so that the total of all debit balances in the general ledger should always match the total of all credit balances.

\(^{25}\) Information system controls are commonly characterized as general and application controls. General controls include system security management, physical access, and segregation of duties. Application controls, sometimes referred to as business process controls, are incorporated directly into computer applications to achieve validity, completeness, accuracy, and confidentiality of transactions and data. GAO, *Standards for Internal Control in the Federal Government*, GAO-14-704G (Washington, D.C.: September 2014), 53, which is effective beginning with fiscal year 2016.

\(^{26}\) The FIAR Guidance provides for performance of substantive procedures as a supplement to, rather than a substitution for, testing internal controls.
internal controls or information about actions taken or progress made toward correcting control deficiencies determined to be dealbreakers. Without such information, DOD and congressional decision makers do not have a complete status of DOD’s audit readiness or sufficient information about improvements that still need to be made. For example, the November 2015 FIAR Plan Status Report identified several audit readiness dealbreakers for each of the services’ equipment. However, other than a general statement that corrective actions needed to be developed and implemented to correct internal control gaps, none of the services provided specific actions taken or interim milestones of intermediate progress made to remediate the dealbreakers. Likewise, none of the services reported actions planned to overcome these dealbreakers that may potentially delay audit readiness of their PP&E. As we have previously reported, DOD components’ efforts to date to implement the FIAR Guidance have not resulted in a fundamental transformation of systems and operations necessary to resolve the department’s long-standing financial management deficiencies. Resolution of these deficiencies will be crucial to DOD’s efforts to meet the September 30, 2017, target date for validating audit readiness of DOD’s full financial statements.27

The NDAA for Fiscal Year 2010 mandated that the semiannual report include details of impediments to the department achieving audit readiness, along with the department’s corrective action plans to resolve the impediments.28 Additionally, going forward, standards for internal control for the federal government require an entity to communicate to internal and external decision makers significant matters relating to risks, changes, or issues that affect the entity’s internal control system.29 DOD officials have stated that they have chosen to include in the report overarching impediments to financial statement audit readiness but have not reported the details of services’ dealbreakers and remediation plans because other sources of that information can be made available to decision makers. However, not disclosing such information in the semiannual Status Report decreases visibility of DOD’s audit readiness

29 GAO-14-704G.
efforts. As DOD continues to refine semiannual reporting, DOD officials have stated that they are considering formatting changes for future Status Reports, particularly information aimed toward addressing dealbreakers. Reliable, useful, and timely information on DOD’s progress toward meeting its audit readiness goals is important to assist Congress in carrying out its oversight responsibilities.

In addition to establishing accountability for all of the department’s PP&E, DOD and the military services must, under current accounting standards, record asset values using an appropriate method of valuation—such as historical cost—for its PP&E to be considered audit ready. However, DOD faces challenges in developing appropriate values for its PP&E because of systems and process deficiencies. The difficulty of that task is exacerbated by the magnitude and uniqueness of DOD’s assets. For example, DOD estimates that it needs to value over 440,000 real property assets along with individual pieces of equipment that may number in the several hundreds of thousands of items located at multiple installations around the world. DOD has stated that many of its existing assets were acquired decades ago, and acquisition cost documents required for supporting valuation and audit were often not retained or cannot be located.

Current federal accounting standards require PP&E assets to be valued and recorded using the actual historical cost of an asset as its value and allow reasonable estimates of historical cost as a substitute for actual historical cost. The recorded value of each asset is to be depreciated and reduced to a net value over the estimated useful life of the asset, except for land, which is a nondepreciable asset.

To date, DOD has been unable to meet accounting standards for valuation because of long-standing deficiencies in its information systems

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30Historical cost is the original acquisition cost of an asset, including costs necessary to ready the asset for use, such as transportation and installation costs.

and processes that prevent managers from obtaining the historical acquisition cost as a basis for valuation or appropriately valuing its PP&E by other means. For example, the DOD OIG reported that DOD does not have property and logistics systems that record and maintain acquisition costs, the cost of modifications and upgrades, or depreciation expense in accordance with established accounting standards.32 Whether for valuing its existing assets or new acquisitions, DOD has acknowledged that it does not have effective business processes, systems, or controls for recording, processing, or accurately reporting actual historical cost or a reasonable method of estimating historical cost. DOD has reported that fixing its long-standing systems deficiencies is a top priority as part of the FIAR Plan’s strategy, and that there are many actions under way by the services and the department to ultimately remediate such deficiencies.

In response to requests from DOD, FASAB, the body responsible for issuing federal accounting standards, undertook a project to address PP&E accounting issues. FASAB’s proposed standard, which would help DOD establish beginning account balances for PP&E, was submitted to the FASAB sponsors (OMB, the Department of the Treasury, and GAO) on May 5, 2016, for a 90-day review, which will end on August 3, 2016.33 The proposed standard includes general approaches to the valuation of opening balances, which would allow DOD to use an alternative valuation method for existing assets that would substitute for actual or estimated historical costs, including the following:

1. For buildings, structures, facilities, and equipment, FASAB is proposing to allow DOD to use deemed cost under several different methods, such as using replacement cost or fair value.

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33Federal Accounting Standards Advisory Board, Establishing Opening Balances for General Property, Plant, and Equipment: Amending Statement of Federal Financial Accounting Standards (SFFAS) No. 6, SFFAS No. 10, SFFAS No. 23, and Rescinding SFFAS No. 35 (Washington, D.C.: Dec. 22, 2015). An accounting standard is typically formulated initially as a proposal after considering the financial and budgetary information needs of citizens, Congress, federal executives, and other users of federal financial information. After receiving and evaluating public comments on the proposed standard (exposure draft), and obtaining review by the three FASAB sponsors, FASAB publishes standards in an SFFAS.
2. For land and land rights, FASAB is proposing to allow DOD to use the following alternative methods: (1) exclude land and land rights on the balance sheet and instead require disclosure of acreage information or (2) recognize opening balances of land and land rights at deemed cost.\(^{34}\)

3. For internal-use software, FASAB is proposing to allow DOD to use the following alternative methods: (1) deemed cost for existing IUS or (2) excluding existing IUS from opening balances and only recording the actual cost of new acquisitions—referred to as prospective capitalization.

The proposed accounting standard would permit DOD to apply alternative valuation methods only to establish opening balances for its existing PP&E.\(^{35}\) Under the standards, DOD would still be required to develop systems and procedures to capture and report the historical costs of newly acquired or constructed PP&E.

In anticipation of being allowed to use these alternative valuation methods, DOD is developing plans to value the majority of its assets with alternative methods. DOD has established working groups charged with (1) developing an approach for establishing valuation methodologies and (2) developing documentation standards for the valuation process for all of its PP&E; however, it is early in the process of determining and implementing such alternative valuation methodologies. Further, DOD and the services have identified challenges in developing and implementing valuation methodologies for existing assets, while continuing to remedy systems and develop procedures to properly account for the actual costs of newly acquired assets for each major category of PP&E. Some of those challenges include the following:

\(^{34}\)Under the proposed standard, land would require disclosure of physical units for accountability. Disclosure of the amount of land in terms of physical units, such as the number of acres or installations, would be similar to the information currently reported for stewardship land. Stewardship land is land and land rights owned by the federal government but not acquired for or in connection with items of PP&E. Examples of stewardship land include land used as forests and parks and land used for wildlife and grazing.

\(^{35}\)Under the proposed standard, if DOD elected to exclude land and land rights, future acquisitions of land and land rights would be expensed and not capitalized.
Equipment. DOD has established an overarching plan for how to value its equipment. However, its application to specific equipment types has not been determined. DOD has identified the following challenges to equipment valuation: (1) numerous configurations of highly complex equipment and weapons systems make them difficult to value, for example, the valuation of enormous costly structures such as Navy ships will be a complex task involving valuing thousands of components that are used to build or modify these ships; (2) certain equipment and weapons systems have been significantly modified, upgraded, or overhauled to the extent that such modifications are considered capital improvements that are required to be capitalized as part of the asset;\textsuperscript{36} and (3) enormous quantities of deployed equipment are located worldwide, posing an increased logistical challenge to valuing all assets.

Real property. DOD has not yet finalized an alternative valuation methodology for real property, including capital improvements. DOD has stated that it does not have systems in place to track capital improvements and has not maintained documentation to support capital improvement costs. As reported by DOD to FASAB, most of its systems used for acquisition of and accounting for real property and capital improvements have either never been audited or have had significant deficiencies or material weaknesses reported.\textsuperscript{37} DOD has cited several complicating factors for valuing its real property, including (1) multiple organizations and systems involved in acquiring real property and capital improvement projects and (2) the lack of consistent processes or documented processes for retaining source documentation related to real property.

\textsuperscript{36}SFFAS No. 6 requires that costs that either extend the useful life of existing PP&E or enlarge or improve its capacity shall be capitalized and depreciated/amortized over the remaining useful life of the associated PP&E. Capitalizing the cost of acquiring or improving an asset means recording the cost as a part of PP&E on the balance sheet rather than to expense it in the year it was spent.

\textsuperscript{37}A significant deficiency is a deficiency, or a combination of deficiencies, in internal control that is less severe than a material weakness, yet important enough to merit attention by those charged with governance. A material weakness is a deficiency, or combination of deficiencies, in internal control, such that there is a reasonable possibility that a material misstatement of the entity’s financial statements will not be prevented, or detected and corrected, on a timely basis. A control deficiency exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.
IUS. DOD has not yet established an alternative valuation methodology for IUS. DOD has stated that identification and valuation of IUS is one of the major challenges to asset valuation.

Valuation alternatives currently being proposed by FASAB, assuming they are adopted as accounting standards, hold the potential to allow DOD to develop an acceptable initial valuation for its PP&E. However, DOD acknowledges that it must still continue to remedy its systems and processes to properly capture and account for the historical costs of newly acquired assets and develop sufficient documentation to enable an audit to be performed. If it is not able to timely implement valuation methodologies for existing assets and remediate identified deficiencies in its PP&E systems, there is an increased risk that DOD may not be able to properly value its assets and be audit ready by the end of fiscal year 2017.

Asset valuation—though a significant challenge for DOD—is required for financial reporting. But beyond financial reporting, there are advantages to tracking and maintaining the records of the historical cost of assets. For example, federal accounting standards indicate that recording and tracking assets—and recognizing the cost of those assets through depreciation expense over their estimated useful lives—helps managers assess the performance of an entity. Additionally, reliable, useful, and timely financial and performance information provides DOD financial managers, Congress, and other decision makers the information they need to make difficult resource allocation decisions and to help ensure that DOD is operating effectively and efficiently.

DOD is responsible for over 70 percent of the federal government’s reported PP&E, but DOD cannot accurately account for its PP&E assets. Significant financial and related business management control deficiencies adversely affect DOD’s ability to manage and perform its mission. DOD’s inability to perform basic financial and accountability functions is highlighted by its inability to prepare auditable financial statements—one measure of good financial management. Congress has required DOD to take steps to be ready for full financial audit by September 30, 2017, and has mandated that DOD report on its status.

38SFFAS No. 6.
and progress through the semiannual FIAR Plan Status Report. Although DOD’s Status Reports have shown that several categories of PP&E are ready for audit, its reporting does not provide clear visibility for Congress and other decision makers regarding the extent to which DOD has addressed underlying deficiencies in internal controls. Further, the Status Reports identify certain control deficiencies, or dealbreakers, that are so severe they could prevent the services from demonstrating audit readiness or succeeding in audits. However, the reports do not provide adequate visibility over actions taken and progress made toward correcting the dealbreakers. Without sufficient information about the status of improvements in internal control, including information about dealbreakers, DOD, congressional committees, and other decision makers do not have a complete status of audit readiness or improvements that still need to be made.

We are making two recommendations to help provide better visibility of DOD’s financial management status for decision makers and to improve oversight of DOD’s audit readiness efforts to strengthen internal controls and improve financial practices and processes. We recommend that the Under Secretary of Defense (Comptroller), while developing other formatting changes to be made in future reports, expand the semiannual FIAR Plan Status Report to include

- the extent to which assertions of audit readiness have been made without assurance that related controls are effective and the details of remediation activities taken and planned to correct the known internal control deficiencies and
- the details of military services’ actions taken and progress made toward correcting the control deficiencies underlying the reported dealbreakers.

Agency Comments and Our Evaluation

We provided a draft of this report to DOD for review and comment. In its written comments, reprinted in appendix II, DOD concurred with our recommendations and stated that its May 2016 FIAR Plan Status Report will provide an increased level of detail regarding critical aspects of achieving audit readiness. DOD further stated that it would use the recommendations to develop and, where appropriate, enhance future semiannual Status Reports to include greater visibility into the progress and impediments related to PP&E audit readiness. Specifically, DOD stated that the Office of the Under Secretary of Defense (Comptroller) will work with the military departments to ensure that their audit readiness
plans include specific milestones for addressing internal control deficiencies. If effectively implemented, DOD’s actions should provide better visibility to Congress and other decision makers in assessing DOD’s plans and actions.

We are sending copies of this report to the Secretary of Defense; the Under Secretary of Defense (Comptroller)/Chief Financial Officer; the Deputy Chief Financial Officer; the Director, Financial Improvement and Audit Readiness; the Director of the Defense Finance and Accounting Service; the Director of the Office of Management and Budget; and appropriate congressional committees. In addition, the report is available at no charge on the GAO website at http://www.gao.gov.

If you or your staff have any questions about this report, please contact me at (404) 679-1873 or cordreyw@gao.gov. Contact points for our Offices of Congressional Relations and Public Affairs may be found on the last page of this report. GAO staff members who made key contributions to this report are listed in appendix III.

William J. Cordrey
Acting Director
Financial Management and Assurance
List of Committees

The Honorable John McCain
Chairman
The Honorable Jack Reed
Ranking Member
Committee on Armed Services
United States Senate

The Honorable Thad Cochran
Chairman
The Honorable Richard J. Durbin
Ranking Member
Subcommittee on Defense
Committee on Appropriations
United States Senate

The Honorable Mac Thornberry
Chairman
The Honorable Adam Smith
Ranking Member
Committee on Armed Services
House of Representatives

The Honorable Rodney Frelinghuysen
Chairman
The Honorable Pete Visclosky
Ranking Member
Subcommittee on Defense
Committee on Appropriations
House of Representatives
The Senate report accompanying S.2410, a bill for the National Defense Authorization Act for Fiscal Year 2015, included a provision for GAO to conduct a review of the Department of Defense’s (DOD) plans to achieve audit readiness with respect to its Property, Plant, and Equipment (PP&E). The objectives of our review were to determine the reported status of DOD’s and the military services—the departments of the Army, Navy (including the Marine Corps), and Air Force—(1) assertions of audit readiness for PP&E asset accountability in accordance with the Financial Improvement and Audit Readiness (FIAR) Guidance and (2) plans for valuing PP&E assets.

To address the first objective, we reviewed the reported status of the military services’ efforts to become audit ready regarding their accounting for General Fund PP&E. We interviewed Army, Navy, and Air Force officials and analyzed documentation to gain an understanding of their processes and systems used to document and report their PP&E accountability audit readiness assertions. We evaluated the documentation the military services prepared to support their assertions using the FIAR Guidance relevant to the period an assertion was made. We obtained and documented DOD’s PP&E accountability assertion status as reported in the most recent November 2015 FIAR Plan Status Report and reviewed the supporting documentation for the reported FIAR status to determine whether they complied with the November 2013 FIAR Guidance. We also reviewed the semiannual FIAR Plan Status Reports issued from November 2010 to November 2015 in order to track the overall progress of the military services’ PP&E audit readiness assertions. We obtained and reviewed audit reports issued by the DOD Office of Inspector General and service auditors regarding the reliability of DOD’s asset accountability records and the effectiveness of their internal controls.

To address our second objective, we obtained a list of all PP&E asset types and identified the systems used to track PP&E valuation information. We conducted interviews with DOD officials responsible for valuing PP&E to determine the status of the valuation process, what valuation methodologies were being planned, and whether supporting documentation was available. We obtained and documented the status of

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DOD’s PP&E valuation assertion as reported in the November 2015 FIAR Status Report. We also monitored the Federal Accounting Standards Advisory Board’s proceedings and discussions regarding proposed accounting standards for the valuation of PP&E.

We conducted this performance audit from November 2014 to May 2016 in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.
Appendix II: Comments from the Department of Defense

OFFICE OF THE UNDER SECRETARY OF DEFENSE
1100 DEFENSE PENTAGON
WASHINGTON, DC 20301-1100

MAY 5, 2016

Mr. Asif A. Khan
Director, Financial Management and Assurance
U.S. Government Accountability Office
441 G Street, NW
Washington, DC 20548

Dear Mr. Khan:


DoD’s semi-annual Financial Improvement and Audit Readiness Plan Status Report has evolved over the years to clearly convey the Department’s strategy and planning, and describe our progress to all of our stakeholders. The May 2016 report, for example, will provide an increased level of detail on planning associated with highest at risk critical capabilities needed for audit. Considering the massive scale of change management involved, we continue to believe that the level of detail provided is appropriate and gives meaningful information to decision makers. We will use the recommendations provided by your report to develop and, where appropriate, enhance future editions. Finally, we acknowledge that in some cases, we have decided to proceed to audit where remediation may not have been completed, judging that the utility of direct audit feedback is more valuable and timely.

The Department appreciates the opportunity to comment on the subject draft report, and appreciate your office’s ongoing engagement and support for efforts directed at DoD’s financial improvement and auditability. My staff point of contact for this matter is Ms. Kim Rouse. Please reach her at 703-614-7532 or kim.m.rouse.civ@mail.mil.

Sincerely,

[Signature]

Mark E. Easton

Enclosure:
As stated
Appendix II: Comments from the Department of Defense

GAO DRAFT REPORT DATED MARCH 31, 2016
GAO-16-383 (GAO CODE 197138)

“DOD FINANCIAL MANAGEMENT: GREATER VISIBILITY NEEDED TO BETTER ASSESS AUDIT READINESS FOR PROPERTY, PLANT, AND EQUIPMENT”

DEPARTMENT OF DEFENSE COMMENTS TO THE GAO RECOMMENDATION

RECOMMENDATION 1: The GAO recommends the Under Secretary of Defense (Comptroller) while developing other formatting changes to be made in future reports expand the semi-annual Financial Improvement and Audit Readiness Plan Status Report to include:

- The extent to which assertions of audit readiness have been made without assurance that related controls are effective, and the details of remediation activities taken and planned to correct the known internal control deficiencies
- Details of military services’ actions taken and progress made toward correcting the control deficiencies underlying the reported deal breakers.

DoD RESPONSE:

The Department concurs with the recommendation from the Government Accountability Office to improve the reporting within the Financial Improvement and Audit Readiness Plan Status Report to include greater visibility into the progress and impediments related to property, plant and equipment audit readiness. The Office of the Under Secretary of Defense (Comptroller) will work with the Military Departments to ensure their audit readiness plans include specific milestones for addressing internal control deficiencies.

Enclosure:
Appendix III: GAO Contact and Staff Acknowledgments

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<th>GAO Contact</th>
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<td>William J. Cordrey, (404) 679-1873 or <a href="mailto:cordreyw@gao.gov">cordreyw@gao.gov</a></td>
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<td>In addition to the contact named above, Paul Kinney (Assistant Director), Shawkat Ahmed (Auditor-in-Charge), Joshua Edelman, and Robert Sharpe made key contributions to this report. Also contributing to this report were Francis Colantonio, Doreen Eng, Maxine Hattery, Jason Kelly, Sharon Kittrell, and Jared Minsk.</td>
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